

**CALIFORNIA HIGH-SPEED RAIL AUTHORITY
ORGANIZATION CODE: 2665**

**FINANCIAL INTEGRITY AND STATE MANAGERS'
ACCOUNTABILITY (FISMA) REPORT**

INTRODUCTION:

In accordance with the Financial Integrity and State Managers Accountability (FISMA) Act of 1983, the California High-Speed Rail Authority submits this report on the review of our systems of internal control for the biennial period ended December 31, 2009.

This report documents the results of the internal review of the Authority's existing systems of management control based on an examination of the control environment and an analysis of the risks inherent in the existing systems. The report is intended to identify any weaknesses that may exist in the systems of control and to provide strategies for mitigation of any perceived risks. The review was performed subsequent to discussion with executive management and key staff, and after a review of the Authority staff functions and responsibilities.

BACKGROUND:

Mission, Goals, and Organization

The mission of the California High-Speed Rail Authority is to plan, design, build, and operate a high-speed train system that provides an efficient, safe, sustainable, and reliable transportation option for the people of California.

The vision of the Authority is: "California's high-speed train system improves the quality of life for Californians, provides a model for the nation, and enhances the state's global economic standing."

The values adopted by the Authority are:

Credibility: offering reliable information and sound expertise.

Integrity: pursuing our mission with the highest personal, professional, and ethical standards.

Transparency: conducting business in an open and public manner.

Collaboration: fostering teamwork within our organization and reaching out for public input and engagement.

Innovation: serving as leaders in our industry and applying new and promising practices for better results.

Efficiency: optimizing resources.

Accountability: being a good steward of the state's assets, delivering on our promises, and upholding the public trust.

At the present time, the Authority does not have a set of formal documented goals and objectives. The Authority has recently contracted with a vendor to assist them in the creation of its Strategic Plan, which will contain the agreed-upon goals and objectives for the high-speed train project. The fact that the Authority does not yet have formal documented goals and objectives makes it difficult to gain an understanding of its environment in relation to its mission-critical goals and objectives. It also makes it difficult to determine risks to the Authority. Therefore, this review focused on key responsibilities of the Authority, as determined through review of relevant documents and interviews with Authority executive management and key staff.

The purpose of the high-speed train system is to provide a reliable high-speed electrified train that links the metropolitan areas of Southern California and the Central Valley with the Bay Area and Sacramento and that delivers predictable and consistent travel times. Further objectives are to provide interfaces between the high-speed train system and major commercial airports, mass transit, and the highway network and to relieve capacity constraints of the existing transportation systems in a manner sensitive to and protective of California's unique natural resources.

Established in 1996, the Authority is the state entity responsible for planning, constructing and operating an estimated \$42 billion high-speed train system serving California's major metropolitan areas. The Authority has a nine-member policy board (five appointed by the governor, two appointed by the Senate Rules Committee, and two by the speaker of the Assembly) and a small core staff. All environmental, planning and engineering work is performed by private firms under contract with the Authority.

Authority staff consists of an Executive Director, three Deputy Directors (Planning/Environmental, Administration/Finance, and Public Affairs) and 7.5 other support positions. The Administration/Finance Deputy Director is also functioning as the Chief Deputy Director. As indicated above, the Authority also employs various contracted vendors who provide technical expertise to the Authority for project management, revenue and cost projections, design, construction and operation of the high speed-train system.

In November 2008, Proposition 1A, the Safe, Reliable High-Speed Passenger Train Bond Act for the 21st Century (AB 3034, Galgiani), a state general obligation bond measure was approved by voters to fund a portion of the costs of the high speed train. This, in addition to the Authority's upcoming application for federal funds, will increase the likelihood of accelerating progress on development and implementation of the high-speed train. The Authority is attempting to obtain additional state staffing as part of the current state budget process to supplement its current minimal staffing level and is looking for additional support for its request. There have been recent proposals by various legislators to alter the governance structure of the Authority and/or other state agencies to affect the responsibilities for development, delivery and operation of the high-speed train. All of

these events, and others, have had the effect of increasing the urgency of a systematic review of the Authority's organizational structure in light of its planned growth and development.

Control Environment

As conveyed in its adopted values, the Authority is committed to an environment of credibility, integrity, transparency, collaboration, innovation, efficiency and accountability in performing its mission. It conveys this philosophy to the staff of the Authority through its direction of staff operations, and helps to ensure overall adherence to the highest standards of conduct by Board members, staff and consultants through the adoption of its conflict of interest code.

Many of the control environment factors described in the Department of Finance's "Guidance for the Evaluation of Internal Controls" relate to the organization's people – how they are organized, how they operate, how effectively they operate, how work is assigned to them, how they are developed and directed, and how they are assigned authority and responsibility. As described above, the Authority has an extremely small staff, given the enormity of the mission of the organization. This fact has created concerns throughout the Authority that the organization does not have sufficient staff resources to maintain effective and efficient systems of internal control. The personnel turnover in the organization has been at an acceptable level, which has been a very good thing, given the small size of the Authority and the problems that the loss of key staff and knowledge would create.

The Authority has acknowledged weaknesses in its systems of internal control particularly in the areas of contract management, expenditure tracking, and invoice review and approval. These weaknesses appear to be driven predominantly by a lack of staff resources. This includes not only a lack of the number of staff needed to carry out the mission of the Authority, but also a lack of the key skills necessary to meet the needs of the organization and maintain effective systems of internal control. The Authority's strategic plan will include goals and objectives for helping to ensure that staff with appropriate skills and authority will be on hand.

The Authority's declared values, as listed above, demonstrate its commitment to operating in an open, honest, accountable and efficient manner, as it establishes cooperative relationships with public and private agencies and with the citizens of California. The staff and management of the Authority appear to be in concert regarding the day-to-day operational philosophy that is being carried out. Job descriptions for all staff and management positions exist, but do not necessarily contain specific references to control-related responsibilities.

As previously indicated the Authority does not yet have a set of established organizational goals and objectives. From a programmatic standpoint, there is an Implementation Plan that has been developed that identifies the project's implementation tasks and schedules. Although this plan does not contain specific goals and objectives, it does provide information on what is to be done and along what timeline. Specific areas

covered include institutional structure; organizing design, construction and operation contracts; technology selection; phasing and staging construction; financing; and schedule.

Similar to the goals and objectives area, the Authority's risk assessment and change management capabilities appear to be concentrated more on the programmatic side than the operational side. The contracted Program Manager has developed a risk identification and mitigation strategy in the Project's Business Plan. However, from an operational standpoint, the Authority has not yet developed such a strategy. The strategic plan will include goals and objectives for helping to ensure that a continuous risk analysis is part of the Authority's control environment.

The existence of control activities at the Authority is not consistent. Management does review actual performance versus budgets, forecasts and prior periods to measure the extent to which targets are being reached, and some controls are in place to check the accuracy and completeness of transactions. Separation of duties to reduce the risk of inappropriate activity is in place. Performance reviews are not consistently completed throughout the organization, and administrative and operational policies have not yet been formalized, although the Authority is in the process of developing such written policies. The strategic plan will contain goals and objectives to help ensure that an annual performance review process is in place and is used effectively by managers and supervisors to evaluate staff.

The internal information and communication systems within the Authority, while adequate in some areas, were generally found to be lacking in overall effectiveness. The timeliness and completeness of operational information (e.g., staff analyses and reports, internal directives/communications) generated within the Authority used for decision-making and carrying out assigned responsibilities is not adequate. It also appears that a general system of communication channels vertically and horizontally throughout the organization is not in place. A key objective in the strategic plan will be to develop and maintain effective communications.

The Authority does have a published Conflict of Interest Code, and for the most part, employs an informal ongoing monitoring system that assesses the quality of its performance over time.

Critical Business Functions, Objectives and Activities

The Authority's critical business functions consist primarily of tasks associated with the planning, designing, building and operating of a high-speed train system. To that end, the Authority contracts with various private sector entities for a variety of tasks. For overall project management purposes, the Authority contracts with an international engineering and project management firm to manage the planning, design, construction and operation of the system and the regional contractors. Regional contractors provide specific technical work on the high-speed train system for planning, design and engineering

aspects of the project. The Authority will contract with a project management oversight firm to provide performance oversight of the project manager.

The project management oversight contractor will review the project manager's compliance with contract requirements relative to agreed upon budget and schedule objectives and is responsible for assessing the appropriateness of the project manager's methods and procedures used to advance program progress. The project management oversight contractor acts as an extension of the Authority staff to monitor the project to determine if it is proceeding within approved work plans.

Management of the overall program becomes increasingly challenging as delivery activities overlap and schedules compress. The Authority must consider and manage a number of separate, often concurrent, activities for different geographical areas of the State and delivery phases of the system, including:

- Development of engineering design criteria and standards to guide the design, construction and operation of the high-speed train system
- Planning, environmental review and permitting
- Preliminary engineering, land acquisitions, and negotiations with existing railroads and public entities
- Procurement, design, construction, testing, commissioning, and training
- Revenue service operation and maintenance of the high-speed train system

To address the management challenges, the Authority established a matrix organizational structure consisting of the project management consulting team and multiple regional consultants to guide, support, and deliver the high-speed train system. The project management consulting team has responsibility for establishing program-level and system-wide requirements that help to ensure quality, safety, reliability, and consistency across all the regional consultants that are preparing the regional project environmental and preliminary engineering studies for the eight regions that make up the 800-mile long high-speed train network planned for California. Dividing the 800-mile route into eight segments provides manageable projects that can be supported by timely regulatory review, assessment and approvals.

The program management consultant team is responsible for activities that take the Project from environmental assessment through preliminary engineering and final design, and on to construction and revenue service, including:

- Program Delivery Planning and Management
- Technical Standards Development
- Regulatory Approvals
- Regional Consultant Oversight and Management
- Procurement

In addition to the business functions discussed above, with the initial planning completed, the Authority must next develop the structure and institutional organization to manage the

construction of the estimated \$42 billion project, help ensure maximum participation and risk-sharing from the private sector, and successfully adapt the existing high-speed train technology to California's needs. Key business functions/activities associated with these challenges include:

- Creating the Institutional Structure
- Organizing Design, Construction and Operation Contracts
- Selecting a Technology Solution
- Phasing and Staging Construction
- Financing the Project

VACANT POSITIONS:

The Authority is in compliance with California Government Code Section 12439. No positions have been abolished pursuant to the provisions of this Government Code section.

RISK ASSESSMENT:

As stated earlier, the mission of the California High-Speed Rail Authority is to plan, design, build, and operate a high-speed train system that provides an efficient, safe, sustainable, and reliable transportation option for the people of California. In the absence of an established set of goals and objectives adopted by the Authority to assist them in carrying out this mission, we used this mission statement and acknowledgement of the Authority's critical business functions from which to base our risk assessment.

In its prior FISMA Report, submitted to the Department of Finance on December 30, 2008, the Authority identified five areas in which management controls could be strengthened. Those areas included:

1. Ensuring that contract deliverables are sufficient to meet contract terms and that contract payments are accurate and timely.
2. Acquiring staff at appropriate levels and with proper skill sets to ensure completion of the Authority's mission.
3. Safeguarding data and information.
4. Safeguarding physical assets.
5. Development of adequate control procedures.

In its Follow-up Report, dated February 4, 2009, the Authority noted the following:

1. "To mitigate the risk of project delays, the Authority's executive management has cancelled its contract with the project management oversight contractor and is in

the process of identifying another contractor to perform the oversight responsibilities.”

Since the Follow-up Report, the Authority did hire another contractor to perform the program oversight. However, that contract was also cancelled and a third program oversight vendor contract was approved by the Board at its December 3, 2009 meeting.

2. “To mitigate the risks of project delays due to inadequate staffing, the Authority has prepared a staffing plan and is in the process of developing duty statements that identify specific classifications and duties needed immediately and in the medium-term future.”

On May 12, 2009, the Authority submitted a letter to the Senate Committee on Budget and Fiscal Review which transmitted a staffing plan for its “immediate and subsequent personnel needs.” In addition, the Authority engaged a private vendor to conduct an organizational assessment which included identification of the key administrative and operational functions the Authority will need to perform, and an assessment of which administrative and operational functions it should consider performing internally and which it should consider contracting out to other state agencies or private entities. Also included were a suggested organizational structure for consideration and a set of duty statements for the suggested executive-level management staff. At its December 3, 2009 meeting, the Board adopted the vendor’s recommendations with some modifications.

3. “The Authority has been engaged in a process intended to secure data and information and preclude project delays due to loss of data. The Authority has issued a contract for off-site storage of archived data tapes. By March 1, 2009, the Authority will have obtained the necessary back-up data archiving equipment and will begin archiving data and information.”

The Authority has executed a contract for the necessary back-up and archiving of its critical data.

4. “Executive management of the Authority has recently assigned staff to develop a process for identifying the status of all equipment purchased or acquired since the Authority was established. Staff will track all purchases and acquisitions to purchase records and disposition logs. Staff will then create an accurate and up-to-date inventory record. All untagged property will be tagged and all property will be identified in the updated property log. Finally, periodic inventories of all physical assets will be conducted to ensure accurate accounting of property. Tracking of acquisition and disposition of all property and establishment of an accurate property log will be completed by June 30, 2009.”

These safeguards are now in place.

5. The Executive Management team recognizes the need to develop standardized policies and procedures to guide the expanding staff toward completion of the Authority's mission. Staff has begun the process of researching existing operational policies of other state entities and identifying those policies and procedures that would be relevant to the Authority. The Authority intends to have basic policies and procedures developed by June 30, 2009."

Although some work has been done in this area, basic operational policies and procedures have not yet been developed by the Authority. These must remain a priority and will be discussed further in this report.

In conducting the current review of the systems of internal control, we performed an assessment of the risks associated with the process of carrying out the Authority's stated mission. This assessment consisted of interviews with key Authority management and staff to identify and document their primary responsibilities that affect progress toward mission accomplishment. It also consisted of a review and analysis of potential risks to the protection of state resources that could result from functional failure and the controls that are in place or that may be needed to mitigate those risks. A number of available documents regarding the high-speed rail project were reviewed for background and identification of key Authority challenges as the project moves forward. These documents included the Authority's last submitted FISMA Report (dated December 30, 2008), the California High-Speed Train Business Plan (updated November 2008), the California High-Speed Rail Project Program Summary Report (dated July 10, 2009), the Implementation Plan (undated version found on CHSRA website), the CHSRA Conflict of Interest Code, and the CHSRA draft Disaster Recovery Plan.

Although we reviewed the Authority's risks in a variety of areas, this review focused on those risks that are most likely to challenge the Authority's anticipated goals and objectives toward achieving its mission to "plan, design, build, and operate" a high-speed train system in California. This report will address areas identified as "high" risk with a "likely" or greater probability of occurring, and where internal controls must be strengthened.

Based on our risk assessment, it appears that the greatest vulnerabilities lie in the areas of operational planning, control policies and procedures, project funding, and project staffing. Specific risks are addressed below in the "Evaluation of Risks and Controls" section of this report.

The Authority is currently undergoing an external audit being conducted by the Bureau of State Audits. This audit of the Authority will include, but not be limited to, the following:

- Review and evaluate the laws, rules, and regulations significant to the audit objectives
- Determine if the Authority is structured to administer and manage the bond proceeds and any other funding in compliance with applicable laws, rules, and

regulations. In addition, assess whether its processes and controls are transparent, provide accountability, and ensure the cost-effective use of public resources

- Identify the steps the Authority's governing board has taken to establish a process for strong project oversight. Assess whether such a process is appropriate and sufficient for ensuring issues are raised and addressed regularly and ensuring that the scope, budget, and schedule for each is on track
- Review and evaluate the Authority's strategic plan to determine if its goals and objectives are reasonable. Assess how management is measuring its performance and whether the Authority is meeting its goals and objectives
- Identify the Authority's funding sources for all major contracts over the past three years
- Evaluate the Authority's contracting procedures and practices for awarding, managing, and monitoring contracts, including procedures to determine the need for contract services, to select contractors, and to measure the performance of contractors
- Determine the Authority's controls to ensure the appropriateness and accuracy of contract payments. Further, review a sample of contracts and paid invoices to ensure they comply with applicable policies, procedures, and controls
- Identify the Authority's expenditures over the past three years. For a sample of these expenditures, determine if they were reasonable and align with the goals and objectives of the Authority
- Review and assess any other issues that are significant to the effective and efficient management of the resources of the Authority

This audit began in September 2009, and is not expected to be completed until February 2010. Therefore, findings from this review are not available to determine if additional risks are identified.

EVALUATION OF RISKS AND CONTROLS:

Following are the significant areas of risk to the Authority's accomplishment of its mission, as identified by this review.

Issue #1: Although it was established in 1996, the Authority has not had a strategic plan from which to operate. Lack of a strategic plan, with identified goals and objectives, will make it very difficult for the Authority to move in an efficient and effective manner toward the accomplishment of its mission.

Corrective Action: Since its inception, the Authority had never engaged in the process of strategic planning. In August 2009, the Authority's executive management recognized the need to begin the process and directed staff to engage a facilitator develop an organizational strategic plan as quickly as possible. The Authority will have a functional strategic plan by the end of January 2010 and a formal plan document by April 2010. Thereafter, it will be a high priority of

executive management to ensure that the strategic plan is updated in a timely manner.

Issue #2: The Authority does not have a published set of policies and procedures from which to guide and control its operations. Given the mission and operation of the Authority, policies and procedures in the areas of contract administration, information security, and fiscal and human resources administration should be given priority consideration. Lack of written policies and procedures for its day-to-day work make it virtually impossible for the Authority to achieve operational consistency and maintain a credible system of internal controls.

Corrective Action: The Authority has been hindered in its ability to establish a formal system of internal controls by a lack of adequate staffing. However, as staffing expands the Authority will be able to more effectively separate duties and develop other formal control mechanisms such as policies and procedures. Authority staff is currently in the process of identifying areas for which policies and procedures are needed and drafting appropriate policy and procedure documents.

Issue #3: The entire high-speed train project is estimated to be a \$42 billion endeavor. In November 2008, California voters approved a \$9 billion bond measure for funding the 800-mile statewide network. That leaves a significant amount of funds left to be secured to pay for this “mega project.” These funds must come from a variety of sources including the federal government, local agencies, and the private sector (public/private partnerships). Without a plan for obtaining the needed funding and the staffing to carry out that plan, the project will not be completed.

Corrective Action: At this point, funding is becoming more secure. With the passage of Prop 1A in 2008, the publication of the updated Business Plan and the application for federal stimulus funds, the Authority can advance the process of obtaining environmental approval, acquisition of rights-of-way, and be in a position to secure additional federal funding and needed local and private partnership investments. No capital construction can be financed from bond funds without a match from other sources. Therefore, various elements of the project will be funded from bond funds and other funding as it is available.

Issue #4: Because the high-speed train project is dependent on outside contractors, particularly the Program Management Consulting Team, it is critical that adequate oversight be conducted by the Authority. At its meeting on December 3, 2009, the Authority Board approved the staff proposal to hire a new Program Management Oversight vendor. Since the prior contract was terminated in December 2008, the Authority executive management team has been providing program management oversight. However, as the project progresses in complexity, it will be increasingly difficult for existing executive staff to provide adequate oversight without this critical oversight role in place. The Authority does not have the internal staff with the skills and knowledge to perform this oversight role.

Corrective Action: The previous Project Management Oversight contractor was ineffective and the Authority terminated the contract. The Authority is in the process of finalizing a contract with a Project Management Oversight consultant and expects to have the contract in place by the end of December 2009. The Authority staff will monitor the Project Management Oversight contractor's performance.

Issue #5: A key milestone in the work plan for each segment of the high-speed rail network is the environmental approval of state and federal agencies. For each section of the 800-mile, statewide, high-speed train system, a regional project environmental review document must be prepared, vetted, analyzed, and approved according to an established environmental review process. Failure to obtain review agency approval would result in potentially significant delays in the project schedule and/or changes to the regional plan.

Corrective Action: The program level EIR/EIS environmental process has been completed and is the basis for the project level EIR/EIS, which is underway. The process depends on progress toward 15% design levels which are still in process. There is little risk that the project environmental documents will not be completed and approved.

Issue #6: Currently, the Authority's budget consists of 11.5 positions to administer the \$42 billion high-speed train project. This is clearly not adequate for the effective administration of a project of this magnitude. The Authority has recently contracted with a vendor to perform an organizational assessment to determine which administrative and operational functions should be performed in-house and which should be considered for outsourcing. The Authority should consider the findings and recommendations of that report, prioritize its true staffing needs, and seek the Administration's approval to hire an adequate number of staff with the requisite knowledge, skills and ability to successfully carry out the mission of the CHSRA. Without appropriate staffing at both the management and staff levels, the Authority will not be able to administer and provide a system of internal controls to successfully plan, design, build, and operated the high-speed train system.

Corrective Action: The Authority is taking steps to ensure adequate staffing. The Authority board has directed Authority staff to implement the organizational plan provided in the organizational contractor's report. The Authority is working with the Department of Finance to secure authorization for the necessary positions. Ensuring adequate staffing is a key objective in the Authority's strategic plan and will remain a priority for executive management.

Issue #7: As stated in Issue #6 above, the Authority is in need of additional staffing at the management level. Significant responsibility and discretion is vested with private contractors, without sufficient oversight by Authority officials. This appears to be due to a lack of sufficient management resources. Executive-level positions in areas such as Program Management, Finance, External Affairs, Project Control and Risk Management,

Internal Audits, and Legal should be included in the Authority's organizational structure. It appears critical that the immediate filling of new management-level positions be considered a priority for the Authority. Given the enormity of the tasks that lie ahead in the near future, the existing management staff will not be able to successfully discharge their responsibilities. They are simply spread too thin.

Corrective Action: The Authority is taking steps to fill the key executive positions as quickly as possible. A key objective in the Authority's strategic plan will address acquisition of adequate staff with the needed skills.

Issue #8: The Authority is staffed with a very small (four) core management team (out of the 11.5 total positions). Three of the four individuals in this core have been with the Authority for a number of years and they possess nearly all of the technical and operational institutional skill and knowledge within the organization. If any of the three were to leave the organization, it would be difficult to replace the lost skill/knowledge in a reasonable period of time. If more than one were to leave at approximately the same time, the result could cause significant delays to the project. The Authority should develop a succession plan to address the potential loss of key institutional skill/knowledge due to turnover.

Corrective Action: The Authority is including a key element in its strategic plan to ensure that an effective succession plan is in place and implemented as soon as possible.

Issue #9: The Authority must secure necessary right-of-way approvals. Right-of-way acquisition is expected to require up to three and one-half years to complete, and involve significant technical and legal issues. This work will include identification of at-risk parcels, preparation of survey documents and legal descriptions, and negotiations for acquisition. Failure to secure the necessary right-of-way agreements could cause significant delays to the project and require re-planning and re-routing of the high-speed train system.

Corrective Action: There is always risk that preferred rights of way will not be secured so as to negatively affect the project schedule and there is no way to completely mitigate that risk. However, through the use of negotiation and focused effort by staff and contractors, the risk can be minimized.

Issue #10: The \$9 billion bond measure passed by the California voters in November 2008 demonstrated the voters' support for the construction of the 800-mile high-speed train system. However, the Authority's ability to access the funds is subject to annual legislative appropriation. Thus far, the Authority has gained the support of the Legislature and the current Administration to provide the funding necessary to move ahead. With the change in Administration coming in January of 2011 and the potential for decreased support from the Legislature, the Authority needs to continue its efforts to maintain and increase the level of support from the Legislative and Executive Branches

of California government. Without such support, the Authority's ability to obtain the necessary State funding to successfully implement this project will be at risk.

Corrective Action: While legislative support is always subject to change, the Authority strives to maintain transparency in its operations in order to secure legislative support. The Authority responds to legislative requests for information quickly and completely. It also meets with other interested parties and provides sufficient data and information to resolve issues as they arise.

CONCLUSION:

During the preliminary stages of the project, the Authority required few staff to be successful. However, as the project has moved from preliminary planning to more defined and complex tasks and responsibilities, the Authority needs to strengthen its systems of internal control. The Authority has already taken action to identify its staffing needs through an organizational evaluation. As indicated above, there are a number of significant risks identified without apparent adequate controls in place which, if not corrected, could prevent the Authority from achieving its stated mission and anticipated goals and objectives. The key areas that would benefit from greater controls are program management and oversight, risk management, fiscal, staffing, and legal.